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In the

Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN WRATHER AND NELL WRATHER, Husband and Wife,
Respondents.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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This case is one of five[1] in which the Government has petitioned for Writs of Certiorari to the United States Court of Appeals for the Fifth Circuit complaining of that Court's judgment that these sales of oil payments are entitled to capital gain treatment under Section 117 of the Internal Revenue Code of 1939. The Government invites favorable consideration by this Court on the grounds

[1]The other four cases are *Lake*, *O'Conner*, *Fleming* and *Weed*.

that the decision below is erroneous, that the decision is in direct conflict with the decision of the Seventh Circuit in *Commissioner v. Slagter (238 F. 2d 901)*, and that questions are presented which are of importance in the administration of the revenue laws.

THE JUDGMENT OF THE FIFTH CIRCUIT IS CORRECT

The petition in this case should be denied because the Court below has reached the correct conclusion. The decision entered results from the application of certain fundamental principles derived from decisions of this Court defining the income tax nature of oil and gas transactions, particularly with respect to oil payments.

Oil payments are created either by transferring a larger oil interest and reserving an oil payment or by carving out an oil payment from a larger oil interest and transferring it to another. In either case the nature of the interest created is precisely the same. In both cases the oil payment is an economic interest in the oil and gas in place entitling the owner to an allowance for depletion on proceeds derived from the sale of production attributable to the oil payment. The reference in the Petition (p. 9) to an "Oil Payment Agreement" in this case can be misleading since it is well established that if the owner of an oil payment must look solely to the oil in place to realize on his investment, there is a true oil payment regardless of the

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[2] *Palmer v. Bender, 287 U. S. 551; Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404; Burnet v. Harmel, 287 U. S. 103.*

form of the conveyance. That an oil payment is "property" would seem to be beyond further argument. The Government does not contend, and never has, that the sale or exchange of other kinds of interests in oil and gas in place[3] results in the realization of ordinary *depletable* income. Just one class of such property has been singled out for this treatment—the carved-out oil payment. Nor is this distinction to be attributed to one or more of the exceptions to the transactions qualifying for capital gain treatment under the provisions of Section 117 of the 1939 Code. In short, it may not seriously be contended that the oil payment sales in this case do not fit the express terms qualifying the gains therefrom as long-term capital gains.

The *non sequitur* is circumnavigated by announcing that the sales in the instant case were in reality not "sales" of "property" at all but were merely anticipatory assignments of income. After many years of the opposite view, the Government reversed its position in 1946, publishing GCM 24849, 1946-1 CB 66, maintaining that thereafter oil payments carved-out and sold which require only one or two years to "pay-out"[4] would be treated as if they were anticipatory assignments of income and the consideration taxed as ordinary income subject to the depletion allowance. In 1950, this view was expanded in IT 4003, 1950-1 CB 10, to encompass all such sales regardless of the length of the pay-out. It cannot be gainsaid that this action was

[3] E. g., oil and gas leasehold or working interests, royalties and overriding royalties.

[4] The expression "pay-out" normally refers to the period of time required for sufficient oil and gas attributable to the oil payment interest owned to be extracted from the ground and sold.

taken without legislative or judicial suggestion or sanction. The Government alleges (Pet. for Cert., p. 20) that taxpayers generally accepted the position set forth in the above rulings. If it were not enough to say that these erroneous legal opinions may not be given the force of law through passive acquiescence of some taxpayers, it need only be pointed out that it has been the subject of controversy since its inception as is exemplified in no small part by these five cases. However, it is noteworthy that the sales here involved were made in 1948, at a time when by the Government's own ruling (GCM 24849, supra) this taxpayer could expect no controversy over capital gain treatment.

The history of the Government's vacillations on this point certainly indicates a recognization of the lack of legal means for adopting the rule presently advocated otherwise than by congressional action. It is submitted that this Court should judiciously refrain from taking legislative action in this case.

This Court's decisions in *Burnet v. Harmel (287 U. S. 103)*, and more recently in *Corn Products Co. v. Commissioner (350 U. S. 46)*, are pointed to as supporting the Government's theory that the oil payment assignment in this case may not be afforded the preferential capital gains treatment. Of course, both the *Harmel* and *Corn Products* cases involved factual situations not even remotely similar to this case. In the *Harmel* case it was held that where upon an assignment of an oil and gas lease the assignor

received a cash bonus and retained a royalty interest, no sale was made. Without a sale or exchange the capital gains provisions manifestly did not apply. In *Corn Products*, the taxpayer engaged in hedging transaction in corn futures. It was found unequivocally that the transactions involved were an integral part of the taxpayer's business designed to protect its manufacturing operations. Such transactions are inherently not capital gains transactions. They are the regular, daily business dealings of the taxpayer and are not the isolated, non-recurring conversion of capital assets represented by the sales in this case.

Justice Stone, in *Burnet v. Harmel*, supra, observed that the capital gains provisions (p. 106):

> "* * * were adopted to relieve the taxpayer from these excessive burdens [referring to high sur-tax rates] on gains resulting from a conversion of capital investments, and to remove the deterent effect of those burdens on such conversions."

Oil and gas property interests are peculiar in that the interest owned is a wasting asset which, on the one hand, is the income-producing asset and on the other, when consumed by extraction and production, becomes the income itself. The pertinence of this proposition lies in the fact that the tax results vary according to the method adopted by the interest owner of realizing on his capital investment therein. Two methods are available: The oil may be extracted from the ground and sold, thereby producing ordinary depletable income, or all or part of the interest owned in the oil and gas in place may be sold or exchanged, there-

by producing capital gains. In the instant case the taxpayer adopted the latter method of realizing upon his investment in the oil and gas in place. The Government is asking that this Court ignore the realities of the transaction and to bunch into a single year to be taxed at high surtax rates income from the production and sale of oil which would otherwise have been taxed over a period of five years.

It is interesting to consider that had the instant taxpayer continued to produce the oil from the leases here involved over the five-year period, taking 27½ per cent depletion thereon, whether or not a greater tax would have been due in the aggregate at ordinary income tax rates than is found to be due as capital gain tax. Actually subjecting the facts in this case to that test by prorating the consideration received on the sale of the oil payments over the five-year period and allowing the depletion deduction, but assuming no other income in each year, the total income tax due is substantially the same as the capital gains tax. Of course, in such a case it might be said that this ordinary income would fall on top of the taxpayer's other income and be taxed at higher rates. It is well known, however, that for men who are actively engaged in exploring for and developing new oil fields, tax losses are sustained which in this case might even have eliminated entirely the income tax on that production. Thus it will not do to say that the

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Unless, of course, the seller is in the business of selling such interests on a regular basis so as to fall within one of the exceptions to the definition of capital gains transactions in Section 117, 1939 Code. This is not the case here as it was stipulated otherwise. (R. 40.)

tax must be collected now at ordinary rates because if the taxpayer had not sold the oil payment he would have paid tax at ordinary rates over the pay-out period.

NO CONFLICT OF DECISIONS

The Government's contention that there is a conflict between the decision below and that of the Seventh Circuit in *Commissioner v. Slagter (238 F. 2d 901)*, is without foundation. It is submitted that the views of the Fifth Circuit and Seventh Circuit are rather perfectly in harmony as will be noted when comparing the decision in *Slagter* with that of the Fifth Circuit in *Commissioner v. Hawn (231 F. 2d 340)*. In both cases each Court concluded from the facts that no *sale* of an oil payment was made but rather that the transactions amounted to loans which were to be repaid to the lenders from the oil payment assigned for that purpose. Therefore, the money received by the assignors was not taxable at all when received but rather it was held that the assignors were taxable on the proceeds of the production attributable to the oil payment as and when received by the assignees in repayment of the advances. This is not the result which was contended for by the Government in either *Slagter* or *Hawn*, nor for that matter in the instant case. It must be recognized that both the Seventh and the Fifth Circuits agree that where from the facts presented, it is plain that no *sale* of an oil payment was accomplished but rather there was a loan transaction, that the proceeds of the loan are not taxable at all.

This being true, neither Court reached the question that if a sale was accomplished, how was the gain to be taxed.

This was the law of the *Slagter* case and while it was contrary to the Government's contentions no petition for certiorari was filed despite the fact that time still remained in which to file such a petition after the decision in this case was handed down by the Fifth Circuit. It appears then that the Government is merely seeking to take an appeal from the adverse decision in the instant case while allowing the time in which to *appeal* in the *Slagter* case to expire.

The Government vigorously argues that the instant case is indistinquishable from the *Slagter* case, notwithstanding the fact that in *Slagter* the assignee of the oil payment, a refinery, had been purchasing the oil from the very same properties all along and was quite anxious to continue to have a call on that oil as well as all the other production of the taxpayer which was available. This fact induced the assignee to make advances to the taxpayer, in the nature of a loan, receiving repayment out of the assigned oil interest. In the instant case the taxpayer and the assignee were wholly unrelated and a loan transaction was in no sense consummated. On the facts, the Court below concluded that a sale had been accomplished.

The Government asserts that the decision below conflicts with certain decisions of this Court concerning the tax results of donative assignments of income.[6] But clearly,

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[6] *Helvering v. Horst, 311 U. S. 112; Helvering v. Clifford, 309 U. S. 331; Harrison v. Schaffner, 312 U. S. 579; Hort v. Commissioner, 313 U. S. 28;* and *Commissioner v. Sunnen, 333 U. S. 591.*

the question here was not presented in those cases, as there, this Court thwarted the taxpayers' attempts to avoid altogether, taxation to themselves of income, in most cases already earned, by transferring the right to receive that income to another.

It is therefore, submitted that no conflict of the decision below with decisions in other circuits or with decisions of this Court exists.

IMPORTANCE OF THE QUESTION

There is no important reason why this Court should feel compelled to review the decision in this case. The lower courts have demonstrated a capacity to dispose of those cases whose facts indicate a lack of substance in a transaction alleged to be a sale, and have done so without doing violence to, or without amending judically, Section 117 of the Internal Revenue Code of 1939. Just as in other areas of Federal income taxation, the courts below, following the teachings of this Court, are indisposed to permit mere form to prevail over substance. In so doing the tax consequences of carved-out oil payments have been construed in such a way as to avoid unwarranted capital gain treatment. It is firmly believed that the "43 docketed and undocketed cases" (Pet. for Cert., p. 21) will be disposed of administratively and judicially without the "loss" of revenue anticipated in the petition.

Moreover, "device" cases may also be expected to run afoul of the refusal judicially to approve employment of

devious means to divert income from the earner thereof to another or to convert ordinary income into capital gain. An outstanding example is the decision in *Rudco Oil and Gas Co. v. United States (Ct. Cls., 1949), 82 Fed. Supp. 746*, wherein the taxpayer declared a dividend to its stockholders which was paid by the corporation by assigning to them an oil payment out of oil properties owned by the corporation. Within three months the stockholders had received from the oil payment the amount of the dividend declared and thereupon the interest reverted to the corporation. The Court refused to permit this "device" to succeed and found the corporation taxable on all the oil runs which had been received by the stockholders.

It would seem not to be inappropriate to conclude this brief opposing the Government's Petition for Writ of Certiorari with a further comment on the question of whether the decision of the Court below in this case has done violence to the intent of Congress in enacting the capital gains provisions. In the instant case the oil interest sold and conveyed was 9 10 of the oil interest owned by the taxpayer. It consumed approximately five years to produce and sell enough oil from that interest to satisfy the amount of the oil payment. It is submitted that this transaction amounts to the sale of a substantial part of the interest owned by the taxpayer and is certainly vastly more than merely a *temporary* disposition of the taxpayer's rights to collect ordinary income. It was in fact, a sale of

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Compare *Commissioner v. Slaughter* and *Commissioner v. Hawn*, both supra.

a part of the income-producing asset or "tree" and not merely the "fruit" of the tree. Manifestly then, this is a conversion of taxpayer's capital investment to which Congress intended the capital gains provisions to apply.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the Petition for Writs of Certiorari should be denied.

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Copies of this brief have been mailed to opposing counsel this 15 day of May, 1957.